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IN THE

Supreme Court of the United States

October Term, A. D. 1935.

No.

NETTIE MEYER, ANNA JACOBSON, JACOB MEYERHOFF, JOSEPH MEYERHOFF, JULIUS MEYERHOFF, JOHN C. PANKIN and RAY MANN,

vs.

KENMORE GRANVILLE HOTEL COMPANY, *et al.*

Petition for a Writ of Certiorari.

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vs.

KENMORE GRANVILLE HOTEL COMPANY, *et al.*

PETITION FOR A WRIT OF CERTIORARI.

To the Honorable, the Chief Justice and Associate Justices of the Supreme Court of the United States:

Petitioners, Nettie Meyer, Anna Jacobson, Jacob Meyerhoff, Joseph Meyerhoff, Julius Meyerhoff, John C. Pankin and Ray Mann, pray the issuance of a writ of certiorari to review the decisions of the United States Circuit Court of Appeals for the Seventh Circuit in dismissing the first appeal on May 28, 1935, the second appeal on July 9, 1935, and at the same time denying the prayer of the petition for leave to appeal, in connection with certain proceedings under Section 77B of the Amendment to the Bankruptcy Act.

A STATEMENT OF THE CASE.

S. W. Straus & Co. floated two bond issues on the Sovereign Hotel. The first bond issue was made in 1919, for $1,000,000 on the "Hotel." The second bond issue was made in 1922 on the "Annex" in the amount of $1,000,000.

The Hotel and the Annex were operated as one unit (Tr. 20) but had separate bond issues. Samuel J. T. Straus was trustee of the "Annex," having succeeded Melvin L. Straus, who resigned (Tr. 46). Melvin L. Straus was trustee of the "Hotel," having succeeded Arthur W. Straus (Tr. 45). The two trustees (officers and directors of S. W. Straus & Co.) were in possession since 1925, because of existing defaults, and managed the property as one unit. A junior bond issue of $250,000 was also floated by the House in 1922 on both the Hotel and the Annex which was foreclosed, and a Master's deed was issued to the purchaser at the sale, Sidney H. Kahn, another officer of S. W. Straus & Co. (Tr. 44). He organized the "Debtor" corporation and conveyed the title to it in October, 1932. The new corporation did not assume the debts and was never in possession. It never functioned.

Three bondholders of the bonds made by the old corporation filed a petition under Section 77B (Tr. 2) against the new corporation claiming that they were "creditors," and the new corporation was a "debtor," and asked for corporate reorganization, but no approval of the petition was sought prior to the hearing on the motion for a receiver in the State Court and the cause was not yet at issue.

Petitioner, Nettie Meyer, a bondholder, filed her complaint (Tr. 38) in the State Court, prior to the approval of the petition, setting forth therein a cause of fraud, gross negligence and conspiracy to deprive the bondholders of their securities by means of a reorganization scheme adopted by the persons who betrayed the interest of the bondholders in the past ten years. Her counsel served notice that he would appear on February 13, 1935, before the Chancellor, and ask to restrain the committee from proceeding with its plan, and for the appointment of a receiver

(Tr. 63). In order to avoid trial there, the "Debtor" voluntarily filed its answer and consent in the District Court on the same day, had the petition approved, and procured a restraining order against the State Court proceedings. When the motion was called in the State Court they urged the Federal restraining order (Tr. 63). Counsel for petitioner appeared and moved to dissolve the injunction and to dismiss the proceedings supported by a verified petition (Tr. 37), but the District Court denied the motion and the first appeal was prosecuted.

The petition, in support of the motion, alleged that prior to the approval of the petition under Section 77B petitioner had filed her complaint in the State Court setting forth therein the floating of the two bond issues by the Straus organization in 1919 and 1922, and that both bond issues were in default since 1925, and the trustees of each bond issue were in possession of the Hotel and Annex, the bondholders were not informed thereof, but on the contrary, when their coupons matured the House paid them. The House instituted a junior foreclosure. The income was applied by the trustees to reimburse the company wherein the two trustees were actively engaged as its officers and directors. The property was acquired in this foreclosure in the name of Sidney H. Kahn, another vice-president of the company, but in reality, S. W. Straus & Co. was the owner. After the company thus became the owner it defaulted in the payment of the taxes, and its two vice-presidents, the trustees, accelerated both bond issues because of the defaults, and instituted foreclosure proceedings, and obtained decrees. S. W. Straus & Co. organized a committee consisting of its officers to serve as a "protective committee," and the bondholders were urged to deposit their bonds with the Straus Bank as depositary. By the terms of the agreement the committee was vested with the legal

and equitable title to the deposited bonds, so that the company which was the secret owner of the property, became the owner of the bonds via its committee. In order to coerce the bondholders to become depositors they informed them that the property will be sold at the foreclosure sale to the committee at the lowest bid and the non-depositors will receive the proceeds of this bid minus all expenses. The committee announced its plan of reorganization which proposed to exchange the bonds for common stock in the corporation, ten per cent of which would be given to S. W. Straus & Co. for its junior interest, and the ninety per cent to be distributed to the depositors. The stockholders would have no voice or vote, but the persons named by the committee would be the trustees and would manage and operate the property, and the cash on hand was to be paid to the committee, to the depositary, to the trustees, and for costs of reorganization. The complaint asked to prevent this fraud and sought the return of the bonds to the bondholders, to hold the defendants liable for their fraudulent acts and gross negligence, and prayed for an injunction, accounting and a receiver.

The petition further alleged that prior to the approval of the petition under Section 77B, appellant served notice for an application to the Chancellor on February 13, 1935, for the appointment of a receiver and for a temporary injunction, but in order to escape trial and to deprive the State Court of its jurisdiction, the alleged debtor appeared that morning in the District Court and filed its answer and consent and procured the approval of the petition, and the restraining order. When they presented the restraining order the Chancellor stated (Tr. 64) that the parties did not act fairly with the Court, and continued the hearing and instructed appellants' counsel to present the facts to the District Court.

The petition alleged that the Kenmore-Granville Hotel Corporation was not a "Debtor"; that the petitioners were not "creditors" because the interest of the corporations which executed the bonds was completely foreclosed, and there was no debtor nor property belonging to the debtor. It also urged that the subject matter in the State Court involving fraud and breach of trust was not dischargeable in bankruptcy and could not be restrained. It alleged that the creditors' petition was not filed in good faith and that the answer of the alleged "debtor" did not confer jurisdiction. It prayed that the injunction be dissolved and the proceedings dismissed for fraud and want of jurisdiction. The District Court denied the prayer of the petition by its order of March 20, 1935 (Tr. 93). An appeal was allowed (Tr. 96) and the appeal was prosecuted and the transcript and brief were filed. This appeal did not operate as a supersedeas, and on May 20, 1935, the District Court approved the reorganization plan with some modifications (Tr. 122-135). Petitioners were allowed an appeal by the District Court from the last order (Tr. 145). Petitioner also filed a petition in the Circuit Court of Appeals for leave to appeal from the final order or to treat the last appeal taken below as a petition for leave to appeal and to consolidate all appeals (Tr. 149-153). The Circuit Court of Appeals dismissed the first appeal on May 28, 1935 (Tr. 105). It dismissed the second appeal on July 9, 1935 and at the same time denied all motions (Tr. 159).

Questions presented.

1. Whether an appeal lies as a matter of right from the approval of a petition for reorganization under Section 77B.

2. Whether an appeal lies from the confirmation of a reorganization plan under Section 77B to review questions of facts.
3. Whether the appeal from a final order is discretionary only with the reviewing court involving only questions of law.
4. Whether a reviewing court may dismiss an appeal on the ground that leave must be obtained to appeal under 77B and at the same time deny such leave so that no mode of review remains open to an aggrieved party.
5. Was it the intent of Congress to make the District Court supreme in passing upon reorganization plans and there is no review on the facts.
6. Is Section 77B constitutional, or are some of its features repugnant to the laws of the land?
7. May a creditor of a corporation whose interest was completely wiped out by a foreclosure which ripened into a deed maintain an action for corporate reorganization against a corporation which did not assume the debt.
8. May a protective committee initiate proceedings in a state court to carry out a fraudulent reorganization, and when sought to be restrained there, obtain the aid of the Federal courts to accomplish its fraudulent scheme and escape liability.
9. May trustees betray the interests of the beneficiaries and grossly mismanage the trust property and escape liability by a proceeding under 77B.
10. Does 77B confer jurisdiction in matters of fraud and breach of trusts which were expressly excluded from bankruptcy prior to the enactment of this section.

11. Whether or not 77B should be used as a shield for fraud.
12. Does the District Court possess the power to approve a plan which exchanges the bonds of the bondholders for stock?
13. May a court take away capital from the first mortgage bondholders and give it to the mortgagor and the other junior interests?

Reasons for the allowance of the writ.

1. The constitutionality of Section 77B was not yet passed upon by this Court, and the question should be settled.
2. The decision of the reviewing court that no right exists to appeal from a final order of confirmation of a reorganization plan is in direct conflict with other decisions which hold that an appeal lies from an order of confirmation.
3. The matters in this case involve important Federal questions dealing with the most recent legislation, and deserve the consideration of this Court.
4. The question of procedure on appeal under 77B is of great importance and should be clarified and settled.
5. If it be true that no appeal lies from a final order of confirmation, then there is no mode of review of the fairness of any plan as the reviewing court, under a petition for leave to appeal, could only consider matters of law.
6. The action of the District Court in approving a plan of reorganization, which took away the bonds from the bondholders and gave them stock and allowed ten per cent thereof to the junior interests and the dismissal of the several appeals on mere motions, deprived petitioners of their rights without due process of law.

WHEREFORE, your petitioners pray the allowance of a writ of certiorari to the United States Circuit Court of Appeals for the Seventh Circuit, that the case herein may be reviewed and decided by this Court, and the judgment and orders herein reversed, and for such other relief as this Court may deem meet.

MEYER ABRAMS,
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Attorneys for Petitioners.

BRIEF IN SUPPORT OF PETITION.

The jurisdiction of this Court to grant the writ.

The jurisdiction here is invoked under 240 (a) of the Judicial Code as amended by the act of February 13, 1925 (43 Stat. 938, 28 U. S. C. A. Sec. 347). The Circuit Court of Appeals for the Seventh Circuit entered its order on May 28, 1935, dismissing an appeal from an order approving a petition for corporate reorganization under Section 77B as filed in good faith and restraining the proceedings in the State Court involving matters of fraud and a breach of trust. It also entered an order on July 9, 1935, dismissing another appeal in the same case from the final order of confirmation of the plan of reorganization on the ground that the order was not appealable below. At the same time, it denied an application for leave to appeal.

It is sought by the petition to obtain a review of the whole case and to settle the practice in connection with appeals under 77B as well as the constitutionality of the whole act.

ARGUMENT.

Preliminary statement.

The petition for corporate reorganization involved two bond issues for $1,000,000 each, one issue was placed in 1919 on the Sovereign "Hotel," and the other, in 1922, on the "Annex." Foreclosure decrees were entered in each case in the State Court. The Hotel decree was entered February 19, 1932, and the Annex decree was entered January 13, 1932. Under the "Hotel" decree a sale could be made at any time, and *the purchaser at the sale will acquire complete title with no equity of redemption.* On the "Annex" decree there will still remain the period of redemption of 15 months after the sale. A proposed plan of reorganization was submitted by an alleged protective committee. The plan was assailed in the State Court for fraud. The committee transferred the plan to the District Court. Nettie Meyer, one of the petitioners, prosecuted an appeal from the approval of the petition and from the denial of her motion to dissolve the injunction which restrained her from proceeding with the State Court proceedings. The appeal was prosecuted in case No. 5491. The transcript and brief were filed, but the Court dismissed the appeal on the ground that appellant had no right to appeal below.

During the pendency of the appeal the Court passed upon the plan. Nettie Meyer and other bondholders (petitioners), in the aggregate amount of $9,000, prosecuted an appeal below from the order approving the plan of reorganization as modified, and also made application for leave to

appeal and to revise, as a matter of law, the final order of the Court, because of the doubt whether the appeal was properly taken below.

All appeals were dismissed and the motion for leave to appeal was also denied.

I.

This is not a controversy between a minority and a majority, but between all the bondholders, and a few persons who claim to represent the large majority, by concealment of material facts and duress.

While it is our contention that the interest of the smallest minority should be safeguarded and protected to the same extent as the large majority yet, *this is not a controversy between the majority and minority bondholders,* but a controversy *between the bondholders,* the real parties in interest, *and a few persons who* have imposed themselves *upon the bondholders* as an alleged protective committee and who have acquired the bonds by concealment of material facts, coercion and misrepresentation. *If the bondholders were acquainted with the facts, the large majority would be on the side of the petitioners.*

The persons who originally constituted the committee, were the officers and directors of S. W. Straus & Co., the issuing house. Two of its present members, Samuel J. T. Straus and Sidney H. Kahn, were the senior executive officers and directors of S. W. Straus & Co., and in the sale of the bonds to the public *they represented that throughout the life of the bond issues, they would safeguard the interest of the bond owners* by collecting monthly the deposits required, in order to promptly meet the payment of interest,

principal and taxes. The bondholders relied on the representations and believed in the good faith of the officers of S. W. Straus & Co. (Tr. 40, 43, 44).

The record shows (Tr. 43) that *both bond issues were in default in the year 1925.* Melvin L. Straus and Samuel J. T. Straus, *the two trustees* under the bond issues *were in possession since 1925.* During the time they were in possession, they permitted the "House" to pay interest to the bondholders and *to reimburse itself out of the income collected, as trustee in possession, without paying the taxes due thereon.* Thereby the bondholders were deceived and took no action to protect their interest.

The two trustees, who were derelict in their duties, procured foreclosure decrees in proceedings (Tr. 44) to which the bondholders were not parties, where they received fees in excess of $50,000. There still remains due on the "Annex" $848,931.51, and on the "Hotel" $618,206.20. S. W. Straus & Co., (the House) acquired the junior lien in said proceeding to the extent of $173,574.34 on the Annex and $202,308.22 on the Hotel. *The two trustees and the members of the committee who were officers and directors of S. W. Straus & Co., therefore, had conflicting interests representing the superior interest* of the bondholders *and the inferior interest* of their "House." (*Meyers* v. *American National Bank,* 277 Ill. App. 378, involving a "Straus" issue; *White* v. *Macqueen,* 360 Ill. 236 advanced sheets.)

The House, its officers and directors and trustees, and the members of the committee, who were its *active* officers, made themselves liable to the bondholders for their gross negligence and misconduct *in paying to the House from the income of the property from the years 1925 up to 1932,* contrary to the provisions of the trust indentures, which required the trustees *to first pay and discharge the tax liens.*

It was also their duty to reveal the information to the bondholders in 1925 when the defaults occurred and *before the collapse in the real estate market.* (*Meyer* v. *American National Bank, supra.*)

These persons who have *appointed from their own midst* an alleged protective committee, lead the bondholders into the belief that the committee was organized for their welfare. They solicited them to deposit the bonds with their depositary (the Straus Bank), without informing them of the real facts.

In order to *coerce* the bondholders to deposit their bonds, they informed them (Tr. 48) that they intended to make foreclosure sales in the two proceedings, and in view of the present real estate market, there would be no other purchasers and the committee would be the successful bidders at the *lowest* price, and *the non-depositors would receive the proceeds of the nominal bid,* less all foreclosure expenses. *The bondholders, who were widely scattered, were thereby coerced to deposit their bonds and to accept the terms imposed upon them by the committee.* By the terms of the depositary agreement the committee became the legal holder and owner of the bonds and *could exchange the superior interest for the inferior interest* or commingle the two interests.

Petitioner, Nettie Meyer, (a depositor), assailed these plans in the State Court, for her own protection and for the protection of all other bondholders (Tr. 37-65). The other petitioners likewise sought relief for themselves as depositors who were *induced to deposit their bonds by the concealment of the facts,* and sought the relief for the benefit of *all* bondholders. The committee which claims to represent all bondholders, also claims to be the representative

of the petitioners. If petitioners succeeded in the reversal of the order, all bondholders would have benefited therefrom.

We emphasize the fact that *this is not a controversy between the few and the many,* but a controversy *between the real parties in interest as against the persons who have not invested a dime in the property,* but who have enriched themselves in the past from the investment of the bond purchasers, and *who betrayed the confidence reposed in them* and are now manipulating to control the property in the future to the detriment of the persons who have invested their hard earned money in the project.

In *First National Bank of Cincinnati* v. *Flersheim,* (290 U. S. 504) 95% of the bondholders have put over a reorganization, which was approved by the District Court, as well as by the Circuit Court of Appeals. This Court reversed it and held that *it was not the duty of the Court to aid the fraudulent plans of the committees even if 95% consented to the plan.* In *Guaranty Trust Safe Deposit* (139 U. S. 143) it was held that the rights of a few bonds will be protected against the millions of bonds held by the committee. In *Cushman* v. *Bonfield* (139 Ill. 219, 243) the Supreme Court of Illinois said that the interest of *one* bondholder is as sacred to the Court as the interest of the others, and it was the duty of the Court to protect such interest. If the Court had jurisdiction of the subject matter and if the plan was fair and reasonable it is the duty of the Court to affirm it. If the Court is without jurisdiction, or if the plan was unfair and inequitable, *it is its duty to set it aside no matter how large the majority is which favors it.* (*1st Nat.* v. *Flersheim, supra*). A court of bankruptcy acts as a *court of equity.* It is guided by equitable principles, and should not lend its aid to accomplish fraudulent reorganiza-

tions. *Parties who are interested as creditors are certainly entitled to their day in court by some method of review,* and the technicalities of the law should not be used to defeat justice. We were either entitled to a review as a matter of right, or to a review by the exercise of the discretionary powers of the Court, from the final order of the confirmation of the plan. *It was certainly beyond the imagination of Congress that a District Court could approve a plan of reorganization no matter how unjust it may be, and there be no right to review.*

II.

An appeal from an order confirming a plan of reorganization is an appeal from a final order and exists as a matter of right.

The distinction between an appeal as a matter of right and an appeal as discretionary, is that on the former the Court may review both the law and the facts, while in the latter, the reviewing Court *may only review the law.* A District Court may approve a most unfair plan, yet no review can be had on the facts if such appeal does not exist as a matter of right. It was certainly not contemplated that there be no review on the facts from the decision of the District Court.

An order confirming a plan of reorganization is not any different from an order confirming a plan of confirmation. The results in both cases constitute a discharge in bankruptcy. The reasoning of the Court in holding that an order confirming a composition is appealable (*United States ex rel. Adler* v. *Hammond,* 104 Fed. 862, 863; C. C. A. 6; *Hamilton-Brown Shoe Co.* v. *Berwald,* 10 Fed. (2d) 275, 276,

C. C. A. 5), well applies to an appeal from the order in the instant case.

The dismissal of the appeal from the order of confirmation was palpably erroneous.

III.

Petitioner Nettie Meyer claimed adversely to the alleged "debtor" and asserted that the District Court was without jurisdiction. She moved to dissolve the restraining order, which interfered with the possession of the res. Such an appeal is appealable as a matter of right.

In the instant case petitioner contends that *there is no debtor and no creditor and no property belonging to the debtor.* The proceedings in the State Court were to take possession of the *res adversely to the debtor.* In *McGonigle* v. *Foutch,* (51 Fed. (2) 455), the Court said (p. 459):

> "Section 129 of the Judicial Code (28) USCA No. 227) provides that 'where, upon a hearing in a district court, or by a judge thereof, * * * an injunction is granted, continued, modified, refused, or dissolved by an interlocutory order or decree, or an application to dissolve or modify an injunction is refused, * * * an appeal may be taken from such interlocutory order or decree.' The Court of Appeals for the Sixth Circuit (*O'Dell* v. *Boyden,* 150 F. 731, 10 Ann. Cas. 239), holds that *such interlocutory order by a court of bankruptcy, which is not one in a mere proceeding in bankruptcy, is reviewable by appeal,* where the final decree therein would be, notwithstanding the jurisdiction of the District Court to grant such injunction is involved. *Bothwell* v. *Fitzgerald* (C. C. A. 9) 219 F. 408, holds such orders to be controversies arising in bankruptcy proceedings, and, as such, appealable."

It further says:

> "Conceding that a restraining order granted without a hearing is not ordinarily appealable, *yet a restraining order which is granted, or sustained, or denied after a hearing of the parties, and which in effect and in everything but name, is a temporary injunction, falls within the evident meaning of the statute, and is reviewable by appeal, and the orders in question were of that character.*" *Western Union Telegraph Co.* v. *United States & M. T. Co.* (C. C. A. 8) 221 F. 545, 553; *Field* v. *Kansas City Refining Co.* (C. C. A. 8) 296 F. 800."

In *Molina* v. *Murphy*, 71 Fed. (2) 605, (C. C. A. 1) a similar question was presented in connection with Section 74. The Bankruptcy Court restrained a foreclosure proceeding in the State Court, and the appeal was taken from the order. On motion to dismiss the appeal the Circuit Court of Appeals said:

> "We do not doubt that the order was appealable. 28 USCA No. 227; *McGonigle* v. *Foutch*, 51 Fed. (2) 455."

In *Lamb* v. *Townsend*, 71 Fed. (2) 590 (C. C. A. 4), the jurisdiction of the Bankruptcy Court to interfere with the *res* possessed by the State Court was challenged, and the Court held that the appeal was proper because it constituted a controversy and not a proceeding in bankruptcy.

A similar question was so decided in *Irving Trust Co.* v. *Fleming*, 73 Fed. (2) 423 (C. C. A. 4). A petition of a creditor to reclaim property was held appealable on the same theory in *B. & B. Glove Corp.*, 279 Fed. 372, 375 (C. C. A. 2).

IV.

The questions presented by the appeals were not mere steps in the administration but distinct and separate issues concerning the right of the alleged debtor to the property, and the jurisdiction of the Court to act.

The conclusion that the District Court was without jurisdiction to grant either appeal is largely due to their failure to realize the distinction between (a) controversies arising in bankruptcy proceedings, which is a matter of right, and (b) proceedings in bankruptcy, which is discretionary. The distinction was well pointed out in *Clark* v. *Huckaby, et al.*, 28 F. (2d) 154, 156, and in *Taylor* v. *Wass*, 271 U. S. 176, the Court said

> "It is now settled by the decisions of this court, that the 'controversies arising in bankruptcy proceeding' referred to in Sec. 24A include those matters arising in the court of a bankruptcy proceeding, which are not mere steps in the ordinary administration of the bankrupt estate, but present, by intervention or otherwise, distinct and separable issues between the trustee and adverse claimants concerning the right and title to the bankrupt estate. * * * In such controversies the decrees of the court of bankruptcy may be reviewed by appeals which bring up the whole matter and open both the facts and the law for consideration."

The petition asserted that the State Court directed the appellant to appear in the District Court and *contest its jurisdiction over the res.* The denial of the motion was appealable, *Bryn* v. *Speakman*, 53 Fed. (2) 463.

V.

The appeals having been taken in time and presenting questions of law, under such conditions the Court should have treated it as a petition for leave to appeal.

Even if it be considered that the proper mode was by leave to appeal the Court should have treated it as such under the settled law. *Grotin* v. *Faith*, 253 Fed. 32, 33; *Duryea Power Co.* v. *Stennbergh*, 218 U. S. 299, 301.

VI.

Section 77B was not enacted to aid the accomplishment of a fraud nor was its purpose to reorganize corporations which never in fact existed.

Courts of bankruptcy are courts of equity, and will not exercise their power to aid a fraud (*Cornwall Press* v. *Ray Long*, 75 Fed. (2d) 276, 277). The District Judge has the duty to "minister in the temple of justice" so that his authority be not invoked for the accomplishment of a fraud. It was equally the duty of the reviewing court to protect itself. The conveyance to the alleged debtor was made in order to put over the fraudulent reorganization prior to the enactment of 77B. This dummy corporation never functioned. It was never in business. It was a mere device to accomplish a fraud. It was a scheme whereby this "myth" was used "to supply a protective cover for a fraudulent design." (*Sherman* v. *Collins*, 75 Fed. (2d) 26.) The whole proceeding was a form to shield the house and its officers from fraud and gross negligence and to reward them and give them the control of the property under a "form of

conveyance *masquerading as a corporate reorganization"* (*Gregory* v. *Holvering,* 55 Sup. Ct. Rep. 266). Such devices cannot succeed to confer jurisdiction (*Soulter Realty Co.* v. *Walker,* 211 U. S. 603; *Miller* v. *East Side Canal,* 211 U. S. 293, 297). It was not the object of Congress to provide corporate reorganization for corporations which *never in fact existed.*

(a) There was no debtor and no creditor and the District Court was wholly without jurisdiction of the corporate reorganization.

Under Section 77B there must be a creditor and a debtor in order to invoke the jurisdiction. (*Bryan* v. *Welch,* 74 Fed. (2) 964, 971; *Brun* v. *Wiesher,* 75 (2) 25, 27; *Draco Realty Corp.* (Bankruptcy Law Service) p. 1148). Here, there was no creditor or debtor. The two corporations which were indebted on the bond issues were foreclosed in the junior foreclosure when Sidney H. Kahn acquired the Master's deed. The new corporation did not assume the debt. It was a mere paper organization for the reorganization purposes. It in fact never existed. The trustees were in possession since 1925, and thereafter the county treasurer was in possession, so that there was neither a debtor nor a creditor within the Act and jurisdiction was actually lacking.

The exact situation was presented to the District Court of New York (*Draco Realty Corporation, Bankruptcy Law Service,* page 1148 decided October 11, 1934). There the Court said

> "From the facts pleaded, it is evident that the petitioners are not creditors of the Draco Corporation. They are creditors of the Winfred Corporation, whose bonds they hold, and they also have a lien on prop-

erty now owned by the Draco Corporation. *But they are not creditors of the latter company.*"

The Court dismissed the petition for want of jurisdiction.

(b) The Kenmore Granville Hotel Corporation was organized for reorganization purposes, and cannot be used as an instrumentality to confer jurisdiction.

Sidney H. Kahn organized the corporation under the reorganization scheme of the committee. It was a mere paper organization which did not exist, and was created in order to accomplish the fraudulent reorganization. Such a corporation is not a proper party for corporate reorganization under Section 77B.

Section 77B of the Bankruptcy Act was designed by its very title as well as the language which its contains to be for the relief of *debtor corporations.* It looked to a situation where a debtor corporation in the pursuit of some legitimate corporate enterprise had met with misfortune and thereby accumulated obligations which it could not pay in the regular course of its business; and sought to provide a method for adjusting the relations of the corporation to its creditors and stockholders in a way which would be equitable to all concerned. It never could have been contemplated that a person or group of persons finding a situation in existence relating to one or more properties, reorganization whereof might be badly needed, could organize a corporation for the *sole* purpose of placing the title to such properties in a corporation and have *it seek relief* under the act in question. Nothing could have been further from the intention of the lawmaking body.

There are various other State and Federal Acts in force which cover such a situation and whereunder the interested parties might find an appropriate remedy. It is difficult

to conceive the effect of upholding the right to resort to 77B under circumstances such as are here disclosed, but it does not require much imagination to see that such a construction of the statute would be far reaching indeed.

The circumstances are, that there was here set up a simulated, sham or fictitious situation which was presented to the Court as the case of a distressed debtor corporation entitled to relief under the act in question, when in fact the title to the debtor corporation was conveyed for the only purpose of itself creating such situation.

(c) The fraudulent reorganization plan intended to be approved by the State Court was transferred to the District Court.

Samuel J. T. Straus, the trustee on the Annex bond issue, was a member of the Protective Committee. Sidney H. Kahn, the senior executive of S. W. Straus & Co., was another member (Tr. 10). It was he who purchased the property at the junior foreclosure sale for his company, and after acquiring the title defaulted in paying the taxes, which precipitated the acceleration of the bond issue by his co-director, Samuel J. T. Straus. These two gentlemen were the members of the co-partnership of S. W. Straus and Company, the instrumentality of S. W. Straus & Co., who placed the bond issues in the market, and later became the secret owner of the property. Melvin L. Straus, the trustee on the "Hotel" bond issue, was a director and vice-president in the same corporation. All the original members of the committee were the active officers of the company. (Tr. 10).

The representations:

It is they who represented to the investors that they recognize having "a duty to their clients" (Tr. 40); that

they would take *every precaution* to safeguard the interest of the investors, and that this precaution will not only be taken at the date of the marketing of the securities, but also *during the lifetime of the bonds* (Tr. 41). They stated that "Too much emphasis cannot be laid upon the amortization and monthly payment features," both of which were "integral parts of the Straus Plan," and that its securities were "*surrounded by a chain of safeguards.*"

Broken promises:

After promising every protection to the bondholders in order to sell them the gold bonds they betrayed the trust and confidence reposed in them. As early as 1925, in the boom of the real estate market, the two bonds issues were defaulted and the mortgagors ceased to exist. Samuel J. T. Straus entered into possession of the "Annex" and Melvin L. Straus, likewise entered into possession of the "Hotel" in May, 1925 (Tr. 48). In reality the Hotel and Annex were but one unit (Tr. 22) and the Straus organization was in possession of the property which was operated as one unit. Under the terms of the sale the bondholders had the right to return the securities at a discount of one per cent (Tr. 40). If the trustees had notified the bondholders in 1925, that the two issues were in default they would have either exercised their option to return the bonds, or would have taken some action (Tr. 52). Therefore, the trustees, interested in the investment house, *concealed* such facts. The House cashed the coupons without informing the bondholders that the issues were in default and it was advancing the funds. Thereby it was able to advertise that the House has a record of "Forty-two years without a loss to any investor" (Tr. 40) and the investors relied thereon and continued to purchase its securities.

These trustees whose *first duty it was to inform the beneficiaries* of the existing defaults and *to use the income in discharge of tax liens* and thereby preserve the security and avoid penalties, *used the income to reimburse the House* for its defaulted bonds and coupons. Because of such diversion of funds, a tax receiver was appointed (Tr. 59). A total of $239,532.43 was paid by the trustees to the House for defaulted bonds and coupons (Tr. 54). The 1928, 1929 and 1930 taxes were not paid. The House, Sidney H. Kahn, and the committee members, organized a corporation known as "Trustees Management Service" and supplied groceries, meats, carpets, furniture, engineering service and supplies (Tr. 56, 57) to the properties "managed" by these trustees, at large profits to the organization, wherein they are all beneficially interested. The promise to safeguard the investors' money by the monthly deposits was broken, and no such monthly deposits were made. The bond owners were not informed of such conditions.

Fraud upon the Court:

With such conditions existing since 1925; with the fact that the House became the owner of the property as a result of the purchase by Sidney H. Kahn at the junior foreclosure sale, and with the knowledge that the interest of Samuel J. T. Straus and Melvin L. Straus (as officers of S. W. Straus & Co., the owner) were in *conflict* with the superior interest of the bondholders, and that they were grossly negligent in diverting the funds from 1925 to 1931, and guilty of deception and concealment of material facts (*Meyer* v. *American Nat. Bank and Trust Co.*, 277 Ill. App. 378) they initiated two separate foreclosures on each of the bond issues as the *sole* representatives of the bondholders, and alleged in their bill that their interest was not in conflict (Tr. 53).

Samuel J. T. Straus, the only representative of the bondholders in the Annex foreclosure, procured the entry of a decrée (Tr. 47), which found that Sidney H. Kahn was the owner. This was untrue and a deception upon the Court. The decree found that certain bonds and coupons were paid between 1925 and 1930 (Tr. 47). Who paid these bonds? The trustee was in possession for the first mortgage bondholders whose rights were superior to those of the House for its defaulted bonds and coupons. *He paid those bonds without even paying the taxes!* For such gross negligence he was rewarded a fee for himself and his counsel in the sum of $27,000! Melvin L. Straus procured a similar decree on the "Hotel" (Tr. 45, 46). If the Court knew of the facts it would have never entered such decrees and approved the accounts of the trustees in proceedings to which the bondholders were not parties.

Serving two masters:

The members of the committee were all active officers of S. W. Straus & Co. (Tr. 53). As such they owed allegiance to it and had the duty to safeguard its interest as "owner" and as the holders of subordinated bonds. As a Protective Committee it was the trustee for the superior lien of the bondholders whose interest was *opposed to that of the "owner" and "junior lien holder."* This committee could only serve one master. *It could not serve the House and the bondholders at the same time.* It was concealed from the bondholders that the House was the owner and the holder of the junior interest until after the entry of the decrees and the adjudication of the rights of the parties (Tr. 52, 53). Could such a committee honestly represent the bondholders? Under the deposit agreement it became the legal and equitable owner of the bonds (Tr. 12). Would the bondholders have entrusted to the active officers of S.

W. Straus & Co., the owner of the property and subordinate interest the right to exchange, subordinate and commingle them? It is this committee which coerced all bondholders to part with their legal and equitable title to their bonds and to deliver them to its depositary, the Straus Bank, at the threat that the non-depositors would be frozen out at the judicial sale (Tr. 50). By such means it accumulated ninety-five per cent of the bonds. They were acquired by deception and duress.

The fraudulent plan:

In July, 1933, the committee announced its plan of reorganization (Tr. 49). A sale was to be made at the *lowest* price, so that the non-depositors would only receive the proceeds of the sale, and will thereby be compelled to become depositors. The depositors who would dissent from the plan were required to pay three per cent of the face amount of their bonds (Tr. 50) and would only participate in the proceeds of the lowest bid. Thereby the committee assured itself that the depositors will not dissent and the non-depositors will become depositors. It gave them *a last chance* to do so until August 12, 1933 (Tr. 30). The bonds of the depositors will be exchanged for common stock and the vote will be vested in the persons selected by the committee (Tr. 24, 25). Sidney H. Kahn is one of the trustees. *Ten per cent of the total issue would be given to S. W. Straus & Co. for its junior interest.* It will be on parity with the bondholders as to the ten per cent, and *will control the ninety per cent through the trustees chosen by its committee!* The cash available will be paid to the committee, to the Straus Depositary, to its counsel, to the trustee, and for reorganization expenses. They did not choose to take the common stock for their fees. They appropriated the cash to themselves.

Prevention of plan:

It was for the purpose of preventing the fraudulent plan in the State Court that appellant commenced her proceedings. She asked for the removal of the trustees, an accounting, for the removal of the committee, for the return of the deposits to her, as well as to all other bondowners. She asked for an injunction and receiver. The hearing was set for February 13, 1935.

Scene changed:

It was this fraudulent plan which was presented to the District Court (Tr. 20). The persons who initiated the fraudulent foreclosure proceedings in the State Court, and who intended to carry out the plan there *via* the two foreclosures, are the same persons who filed their plan in the District Court. Should the District Court have lent its aid to such a committee? Should it have interfered with the jurisdiction of the State Court to enjoin such a fraudulent scheme? Was it not its duty to dismiss the proceedings when the facts were disclosed to it from the petition of this appellant?

The consent was given by the "Debtor" on the day the matter was set for hearing in the State Court. This was done in order to deprive it from jurisdiction. This was fraud *per se.* (*Harkins* v. *Brundage,* 276 U. S. pp. 45, 56.) The answer of the "Debtor" did not reveal the facts to the Court. *Its aid was invoked to escape trial on charges of fraud and gross negligence.* It was invoked to put over this fraudulent plan.

Deceptive statements:

The bond issue on the Hotel was made in 1919. Under the Illinois law pertaining to mortgages made in the years 1917 to 1921 *no redemption rights existed after the foreclosure sale.* (*Smith-Hurd,* 1933 Ill. Rev. Stat. Chap. 77, Sec. 16, p. 1733.)

The decree on the "Hotel" was entered February 9, 1932. (Tr. 45.) If the trustee had made the sale at the expiration of fifteen months, on May 10, 1933, the purchaser would have obtained a Master's deed and *the interest of S. W. Straus & Co. as "owner"* and "junior mortgagee," would have been completely wiped out and the bondholders would have received the title to the whole property. This was not to the interest of the House, its committee, and its trustee, so no sale was made! With knowledge of the facts that under the law pertaining to this issue the period of redemption no longer existed from the date of the sale it stated in the plan (Tr. 24) that the ten per cent was given to avoid a redemption and thereby "substantially shortening the time required to effect the reorganization." Why should a bondholder of the "Hotel" surrender ten per cent when the trustee could have made the sale and thereby acquire the title without any toll to the company? It is the dual position of the committee which is responsible for such result. It is serving its Master, the House, which solicited it.

When the petitioner, Nettie Meyer, presented her petition and pointed out to the Court the features of the inequitable plan, the mode how the committee acquired her bonds as well as the ninety-five per cent of the other bondholders', when it learned of the betrayal of the trust duties and obligations and the fraud that was put over in the State

Court proceedings, and that a hearing was set there to obtain some relief and to prevent the accomplishment of the fraudulent plan, it was his duty to dismiss the proceedings for bad faith and want of jurisdiction.

Certainly it was the duty of the reviewing court to hear the case on the merits even if there was no appeal below as it could have treated it as an application for leave to appeal.

(d) It was the duty of the District Court to relinquish its jurisdiction in favor of the State Court.

In two of its most recent decisions this Court held (*Penn.* v. *Williams*, 294 U. S. 183; *Penn. General Casualty Co.* v. *Penn.*, 294 U. S. 195, 75 L. Ed. pp. 385-392) that Federal Courts should decline to interfere with State jurisdiction, and it is their duty to relinquish such jurisdiction. Here was a case which was pending in the State Court for years. The same plan was to be submitted in the State Court. It was attacked there as a fraud by Nettie Meyer, one of the petitioners. Under the views expressed by this Court in the above decision it was the duty of the District Court to decline to interfere with the pending proceedings. The State Court had taken jurisdiction of the *res* and of the subject matter involving fraud and an express trust, both of which were peculiarly within its sole jurisdiction, and the Federal Court was without jurisdiction to interfere. (*Reconstruction Finance Corp.* v. *Zimmerman*, 76 Fed. (2) 313, 4 C. C. A.)

VII.

The amendment to the Bankruptcy Act in so far as it interferes with the jurisdiction of all courts and vests exclusive jurisdiction in the District Court without regard as to the time and progress of the proceeding, is a legislative encroachment on the judiciary and is repugnant to the spirit of the Constitution which provides for a separation of powers.

The government, under our Constitution, is divided in three departments—the Legislative, Executive and Judicial. Each is supreme in its own sphere. The encroachment of one department on another is prohibited (*Kilbourne* v. *Thompson*, 103 U. S. 168). The Constitution vests the judicial power in the judiciary and its power is indestructible by the legislative branch. An extension of jurisdiction of a court can only be made if it is not infringing on the jurisdiction of any other court (*Sampeyreae* v. *U. S.*, 7 Pet. 222, 8 L. Ed. 665).

(a) Section 77B is an encroachment both on the Federal Courts, as well as on the State Court.

A court may have a case under its exclusive jurisdiction for years, and have devoted a great deal of time in deciding many of the issues involved, and a party may defeat its jurisdiction by the mere filing of a petition. The subject matter in the equitable proceeding may be completely foreign to bankruptcy, yet, a Bankruptcy Court may deprive it of the exercise of its jurisdiction. A court may be engaged in the middle of a trial involving fraud and the defendant, to escape punishment for his fraudulent act, may file a petition for reorganization, and the

tribunal is powerless to act. The amendment to the Bankruptcy Act destroys the sovereignty of all courts and deprives them of their functions and duties and relegates them to mere puppets subject to the control of any District Judge who may, by the stroke of his pen, annul the painstaking efforts of a court of competent jurisdiction. There is no limit as to time nor subject matter. A final decree of a court of equity is annulled by the act, no matter when rendered. Such an amendment deprives the judiciary of its function and is contrary to the very letter and spirit of our constitutional form of government.

The *tripartite* distribution of power is the fundamental system of our constitutional form of government. It is beyond the power of Congress "to withdraw from judicial cognizance any matter from which by its nature is the subject of a suit at common law or in equity or admiralty (*Williams* v. *U. S.*, 289 U. S. 555, 579)." It is essential to the successful working of the system "that the person who is entrusted with power in any one of these branches shall not be permitted to encroach upon the powers confided to the others (*Kilbourne* v. *Thompson*, 103 U. S. 168, 191).

(b) Section 77B in so far as it attempts to control matters which have proceeded to final judgment or decree is void.

The legislature may control remedies, but when the matter has proceeded to judgment, it has passed beyond legislative control (Cooley's Constitutional Limitations, p. 192). The act removes a case from the control of the Court without regard to the finality of the judgment and the stage of the proceedings. It is an usurpation of the powers of the judiciary.

(c) The Court was without jurisdiction to exchange the bonds for stock and to place the junior interest on a parity with the superior interest.

The plan which the District Court approved, exchanged *the bonds for stock* and gave a ten per cent interest to the *junior interest on a parity with the superior interests.* It is our contention that the Court was without jurisdiction to do so, and if the intent of Section 77B was to vest the Court with the power to abrogate the obligations of contracts, then it was repugnant to the Constitution of the United States. In construing the Frazier-Lemke Act under Section 75S, the Supreme Court of the United States says (*Louisville Joint Stock Bank* v. *Radford,* 79 Law Ed. 920, 929):

> "No Bankruptcy Act had undertaken to supply him capital with which to engage in business in the future * * * but unless the mortgagee released his security, in order to prove in Bankruptcy for the full amount of the debt, a mortgage even of exempt property was not disturbed by bankruptcy proceedings."

It further says:

> "No Bankruptcy Act had undertaken to modify in the interest of either the Debtor or other creditors any substantive right of the holder of a mortgage valid under Federal law."

The Court further says:

> "The bankruptcy power, like the other great substantive powers of Congress, is subject to the 5th amendment. Under the bankruptcy power Congress may discharge the Debtor's personal obligations, because, unlike the States it is not prohibited from impairing the obligation of contracts * * * but the effect of the Act here complained of is not the discharge of Redford's personal obligations. It is the taking of sub-

stantive rights in specific property acquired by the bank prior to the act. * * * No provision permits the mortgagor to obtain a release or surrender of the property before foreclosure without paying in full the indebtedness secured."

In the instant case substantial property rights were taken away from the bond owners, the mortgagees, and surrendered to the defunct corporation, which is not even the mortgagor, and other rights were taken away from the bond owners and given to the junior lien holders. The capital of the mortgagee was taken away to supply capital to the corporation which never was possessed of the property, which was never in business. It is a violation of the Constitutional right, and certainly a party ought to have his day in court.

CONCLUSION.

The record in this cause discloses the inner workings of the "investment banker," which controls (1) the "promotion" of the securities and their "manufacturer"; (2) the distribution to the investors; (3) the trust company, which was to protect the investors; (4) the machinery of the court proceedings; (5) the judicial sale; and (6) the control of the property via its protective committee. (See "Other People's Money," by Mr. Justice Brandeis.)

What a picture this record presents!

Two separate bond issues were floated for $1,000,000 each on a property which could only be operated as one unit. The two bond issues were defaulted as early as 1925. The two trustees were in possession since 1925, but such facts were concealed from the bondholders. The trustees who were in possession for the benefit of the bondholders, paid the income to the House on its defaulted bonds. The House

became the owner. Its active officers became the Protective Committee for the bondholders. The House as "owner" failed to pay the taxes, and the trustees, its officers, foreclosed the two bond issues. They foreclosed against themselves, against the House they represented. On the one hand they were interested in the equity owned by their company, and on the other hand, they claimed to represent the bondholders whose interest was superior. The committee was in the same dual position. They were both serving two masters, but held out to the Court that they only served one, the bondholders. They prepared a plan of reorganization, which would deprive the bondholders of their security and place the Straus organization in control of the property for fifteen years. When an attempt was made to stop their scheme in the State Court, they sought refuge in the District Court.

The District Court assumed jurisdiction and approved the plan with certain modifications. The bondholders were relegated to valueless stock holders. The junior interests were given ten per cent of the stock on parity with the superior interest. The suit for fraud and gross negligence was permanently restrained. No review was allowed! Will this Court permit such a procedure? Does this constitute due process?

We hope that this Court will allow the writ.

Respectfully submitted,

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